



## Bull Call Spread

BACK TO BASICS: Spread Yourself Around: Example

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Options are a fantastic investment to make money on the rise and fall of an asset. This is no surprise to anyone unless the first time you've ever heard of an option was in the preceding sentence. There are two kinds of options: calls and puts. Calls give traders the right to buy an asset at a specific price on or before a specific date; puts provide the right to sell an asset at a specific price on or before a specific date. When bought as a single contract, they offer unlimited reward with limited risk. Not bad, right? How would you like to reduce risk even further, while still keeping your appreciation potential high? Interested? Sure you are. Options spreads offer you a means to do just that.

Spreads composed of options with the same expiration date and different strike prices are known as vertical spreads. There are two types of vertical spreads: debit spread and credit spreads. Debit spreads include a bull call spread and a bear put spread—each one makes a profit in a bullish or bearish market respectively. Credit spreads include bull put spreads and bear call spreads. A bull call spread involves buying a lower strike call and selling a higher strike call against it. For example, if you wanted to create a bull call spread using XYZ Company's stock trading at \$31 per share, you could buy an XYZ March 30 call for \$4.00 and sell an XYZ Mar 40 call for \$2.00. Your net cost (maximum limited risk) is \$2.00, or \$200 per spread. This is the absolutely the most you can lose even if XYZ falls to a penny a share. This is because that for every dollar you make on the call you purchased, you lose a dollar on the one you sold. Your reward potential can be calculated as the difference in strike prices minus your net debit. Therefore your maximum reward is \$800 ( $\$10 - \$2 = \$8$ ). Your reward to risk ratio is 4 to 1—you're risking \$2 to make \$8. Would you place this trade if your prospects for XYZ were good? I certainly would! Trades like this exist every day if you're willing to look for them and structure them on appropriate assets. You can often find trades with reward to risk ratios of much higher than that. I would not look at a spread with a reward to risk ratio of less than 3 to 1 unless the probability that the trade would materialize in my favor was extremely high.

In contrast, a bull put spread consists of buying a lower strike put and selling a higher strike put against it to create a net credit—the maximum profit available on the spread. The hope here is that the stock will continue to rise and your long put will be worth more than your short put.

As you can see, the ability to utilize either calls or puts doubles your chances of finding a great trade. Whether you use calls or puts, your overall outlook is bullish on the stock and I recommend that you look at both sides before making up your mind as there can often be a big difference between the reward to risk ratio between the calls and puts when placed as a spread. Placing the trade is as simple as calling your broker and telling him or her that you want to place a spread order to open a position and saying: "I want to place a spread order to open a position. 'I want to buy the XYZ March 30-40 call spread at a net debit of \$2.00.'" Getting out of the trade is accomplished by calling up and telling him or her you want to close an existing position and saying: "I want to sell the XYZ March 30-40 call spread at a net credit of \$8"

The opposite side of the market is the bear side! I am an eternal optimist, so I don't place many bearish trades unless the prospects for the company are bleak at best. A bear put spread is a debit spread comprised of buying a higher put and selling a lower put against it. The bear call spread is a credit spread that consists of the purchase of a higher call and the simultaneous sale of a lower call. Placing the order is done the same way as in the bearish examples and the reward to risk ratio is figured the same way. The most important factor when trading spreads is the probability that the trade will move as you expect. With a low probability, it is not even tempting to take a trade with an extremely high reward to risk ratio. For more detailed information about these innovative strategies, go to the [Optionetics.com](http://Optionetics.com) website and click on "trading education."

A great advantage to spread trading is that you can utilize LEAP options which gives you a longer time frame in which to be right. This increases your probability that you will be successful in the trade. Spreads cost less than the outright purchase of calls or puts and allow you to more thoroughly diversify your holdings so that you don't break the old rule about putting all your eggs in one basket.

A bull call spread is a debit spread created by purchasing a lower strike call and selling a higher strike call with the same expiration dates. This strategy is best implemented in a moderately bullish market to provide high leverage over a limited range of stock prices. The profit on this strategy can increase by as much as 1 point for each 1-point increase in the price of the underlying asset. However, the total investment is usually far less than that required to purchase the stock. The strategy has both limited profit potential and limited downside risk.

#### Steps to Using a Bull Call Spread

1. Look for a moderately bullish market where you anticipate a modest increase in the price of the underlying stock-not a large move.
2. Check to see if this stock has options.
3. Review call options premiums per expiration dates and strike prices.
4. Investigate implied volatility values to see if the options are overpriced or undervalued.
5. Explore past price trends and liquidity by reviewing price and volume charts over the last year.
6. Choose a lower strike call to buy and a higher strike call to sell with the same expiration date.
7. Calculate the maximum potential profit by multiplying the value per point by the difference in strike prices and subtracting the net debit paid.
8. Calculate the maximum potential risk by figuring out the net debit of the two option premiums.
9. Calculate the breakeven by adding the lower strike price to the net debit.
10. Create a risk profile for the trade to graphically determine the trade's feasibility.
11. Write down the trade in your trader's journal before placing the trade with your broker to minimize mistakes made in placing the order and to keep a record of the trade.
12. Contact your broker to buy and sell the chosen call options.
13. Watch the market closely as it fluctuates. The profit on this strategy is limited-a loss occurs if the underlying stock closes at or below the breakeven point.
14. To exit the trade, you need to sell the lower strike call and buy the higher strike call or simply let the options expire. The maximum profit occurs when the underlying stock rises above the short call strike price. If and when the short call is exercised by the assigned option holder, you can exercise the long call and deliver those shares to the option holder at the lower long call price, pocketing the difference plus the premium from the short call.



## Picking the Right Strategy

Often the biggest problem newcomers to options trading face is choosing which strategy is the most appropriate to use under a given set of market conditions. It's easy picking a stock strategy; you either buy or you sell. Stock prices are not affected by time and volatility. Since options have multidimensional attributes, the trader is faced with the same choice of buy or sell, but also needs to determine such things as volatility, time and delta. It seems that ever since we started trading sideways, everyone has picked "the bottom," and are therefore attempting to trade bullish positions. This isn't necessarily a bad thing; however, the rationale is disturbingly biased, particularly from the media heads.

One of the most important things a trader can do is forget about what the market might do and determine what it is doing. Then set up a play that will pose limited risk should you be wrong.

So aside from experience, how do you determine what the market is telling you and how do you know what strategies to use? In order to avoid the risk of turning this into a discussion on technical analysis, I will only mention that there are plenty of technical and fundamental indicators that you can use to determine the trend. After you have determined the trend, you need to get some idea of the volatility of the market and the underlying stock you are going to trade. (Though you can get this from other sources, I must shamelessly plug our Platinum site as my personal favorite source for this data.) From there, you can determine what is the most appropriate strategy that has the highest probability of becoming profitable.

Of course, in order to keep from inundating yourself from information overload, it's best to keep your strategies for each scenario to a minimum. As you progress as a trader, experiment with variations of the strategies, or new ones to accommodate your evolving personality. For example, in a bullish market with low volatility—although you can choose from a number of strategies—it might be best to practice with just bull call spreads until they become so boring that you're making too much money (ha, never!). Then maybe start to experiment with ratio back spreads.

The following chart illustrates that indeed you can make money in any market. I've put together a matrix of one example of a strategy I would be using under each of the various market conditions. I suggest you do the same with the strategies you currently know and understand. If you come to an empty cell that you cannot think of a strategy for, that's what you need to research. Keep the matrix at your side until you can trade your strategies cold. Keeping with the

Optionetics methodology, all of the following are spreads of some kind. As the saying goes, better spread than dead!

	<u>High IV</u>	<u>Neutral</u>	<u>Low IV</u>
<u>Very Bullish</u>	ITM Bull Put (credit)	OTM Bull Call (debit)	Call Ratio Backspread
<u>Bullish</u>	OTM/.ATM Bull Put (credit)	OTM Call Calendar	ATM Bull Call (debit)
<u>Neutral</u>	ATM Calendar Spread	Iron Butterfly	Straddle
<u>Bearish</u>	OTM/ATM Bear Call (credit)	OTM Put Calendar	ATM Bear Put (debit)
<u>Very Bearish</u>	ITM Bear Call (credit)	OTM Bear Put (debit)	Put Ratio Backspread

You probably noticed that in more than half of the above strategies, I've entered whether the play should be out-of-the-money [OTM], at-the-money [ATM] or in-the-money [ITM]. Although these choices are only my opinion, the point is that I have determined what I believe to be strategies that take advantage of higher leverage with an appropriate balance of risk/reward.

Speaking of risk/reward, when you've determined the market and the strategy you wish to seek out, the next thing you want to determine is how much risk you would like to take on for each play. As an example, I won't put on a credit spread for any less than \$1 for every \$5 difference between strikes. On debit spreads, I won't even look at them unless the minimum reward potential is 200% return. That's not to say that I have to make 200%; just that on a 10 point spread, I only have to put up a maximum of \$3.30 to make the \$6.70. This is the same for all other spreads. You should decide for yourself how much you are willing to risk for every debit spread, calendar spread, etc.

Everything in trading should be calculated, and nothing should be spontaneous. Unfortunately, for the speed traders, boring makes money. The only truly successful traders I've ever known actually research the market and their trades prior to putting them on. Gone are the days where we can blindfold ourselves and throw darts at the Wall Street Journal.

Until next time, happy trading...

Michael Bennett  
Staff Writer  
Optionetics.com

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## A

**adjustment** The process of buying or selling instruments to bring your position delta back to zero.

**at-the-money** An option that has a strike price equal to the underlying market price.

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## C

**call** An option contract giving the holder the right, but not the obligation, to buy a specified amount of an underlying security at a specified price within a specified time.

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## D

**delta** The change of the price of an option relative to the change of the physical underlying.

**delta neutral** Any position in which the total deltas of the position add up to zero.

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## E

**exercise** The process by which the holder of an option notifies the seller of their intention to take delivery or make delivery of the underlying instrument at the specified exercise price.

**exercise price** The price at which the underlying will be delivered in the event that the option is exercised.

**expiration** The date and time after which an option may no longer be exercised.

**extrinsic value** The price of an option less its intrinsic value. An out-of-the-money option's worth consists of nothing but extrinsic or time value.

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## F

**fair value** The theoretical value of what the option should be worth.

**fixed delta** A delta figure that does not change with the change in the underlying.

**front month** Usually the option with the shortest time to expiration or the future with the nearest time to delivery.

**futures contract** A contract between buyer and seller whereby the buyer is obligated to take delivery and the seller is obligated to make delivery of a fixed amount of a commodity at a predetermined price at a specified future date.

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## G

**gamma** The change of an option's delta relative to the change in the price of the underlying instrument.

**go long** To buy securities, options or futures with the intent to profit from a rise in the price of the asset.

**go short** To sell securities, options or futures with the intent to profit from a drop in the price of the asset.

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## H

**hedge** To create a trade which lowers the risk of an outright directional move (i.e. to go long one security, short another security).

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## I

**illiquid market** A market which has no volume that subsequently creates a lot of slippage due to lack of trading volume.

**immediate/cancel** An order which must be filled immediately or canceled.

**index** An index (or indices) is a group of stocks which make up a portfolio in which performance can be monitored based upon one mathematical calculation.

**in-the-money** An option which could be exercised and immediately closed out against the contract for a cash credit. A call is in-the-money if its exercise price is lower than the current market price of the underlying instrument. A put is in-the-money if the exercise price is higher than the current market price of the underlying instrument.

**intrinsic value** The real value of an option. This is determined by calculating the difference between the price of the underlying asset and the in-the-money option's strike price.

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## L

**leverage** The amount of volume that enables a trader to buy or sell a security or derivative and receive fair value for it.

**limit move** The maximum daily price limit for an exchange traded contract.

**limit order** An order which must be filled at a specific price or better.

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**liquidity** The amount of volume in a futures or options contract.

**locked market** A market where trading has been halted because prices have reached their daily trading limit.

**long** A position resulting from the purchase of an underlying stock, option, commodity or futures contract.

**low (lo)** The low price of a security or derivative for a certain time frame.

**low risk investing** A trade which is hedged for purposes of limiting price loss as opposed to a directional trade where loss is unlimited.

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## M

**margin** A deposit made by a trader with a clearinghouse to ensure that he/she will fulfill any financial obligations resulting from his or her trades.

**margin call** The need for additional money to be deposited into an account to maintain a trade.

**mark-to-market** At the end of each trading day (and all following days a position remains open), the contract value is credited or debited based on that specific trading day's session. In this way, losses are never allowed to accumulate.

**market maker** An independent trader or trading firm that is prepared to buy and sell shares or contracts in a designated market. Market makers on stock or stock option exchanges perform functions similar to locals on the exchanges. The difference with market makers is that they must make a two-sided market (bid and ask).

**market on close** An order that is filled as a market order on the close of the trading session.

**market order** An order that is filled at the current market price.

**momentum** When a market continues in a certain direction for a specific time frame.

**momentum trading** Investing with (or against) the momentum of the market in hopes of profiting from it.

**moving average** The average of a number of time frames to smooth out a direction of the market.

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*Continued on back*

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## N

**naked option** An option written (sold) without an underlying hedge position.

**net change** The daily change from time frame to time frame. An example would be the change from the close of yesterday to the close of today.

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## O

**offer down** The change of the offer of the market related to a downward price movement at that specific time.

**option** A security that represents the right, but not the obligation, to buy or sell a specified amount of an underlying security at a specified price within a specified time.

**order** A ticket or voucher to buy or sell securities.

**opportunity cost** The cost of using your capital for one investment versus another. For example, if you have \$10,000 in one investment, this is \$10,000 that cannot be used elsewhere.

**option premium** The price of an option.

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## P

**put** An option contract giving the holder the right, but not the obligation, to sell a specified amount of an underlying security at a specified price within a specified time.

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## R

**risk graph** A graphical representation of risk and reward on a given trade as prices change.

**risk manager** A person who manages risk of trades in a portfolio by hedging their trades.

**risk profile** A determination of risk on a trade. This would include the profit and loss of a trade at any given point for any given time frame.

**roundturn** A fee or commission cost charged by a brokerage to cover the trades made to open and close each position. Usually paid upon exiting the trade.

**running stops** Something which when quoted, floor traders use to move the market. When stops are bunched together, traders may move the market in order to activate stop orders and propel the market further.

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## S

**series** All options of the same class with the same exercise price and the same expiration date.

**short** A position resulting from the sale of a stock, option or contract. Note that a short put position is a long market position.

**short premium** Expectation that a move of the underlying in either direction will result in a theoretical decrease of the value of an option.

**spread** An order to simultaneously buy and sell at least two different contracts at a quoted differential. A long market position is usually offset by a short market position, but not always, with contracts in the same underlying.

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## T

**technical analysis** The study of price action based on mathematical formulas (i.e. moving averages, stochastics and relative strength index).

**technical indicator** A bullish or bearish numerical indicator used to help predict future price movement.

**theoretical value** An option value generated by a mathematical option's pricing model to determine what an option is really worth.

**theta** The change of the option's value relative to change in time.

**ticket** An order form for a security or derivative for a certain time frame.

**time decay** The amount of time premium movement within a certain time frame on an option due to the passage of time in relation to the expiration of the option itself.

**time premium** Another name for extrinsic value. The additional value of an option due to the volatility of the market and the time remaining until expiration. Premium minus intrinsic value.

**time spread** A spread consisting of one long and one short option of the same type with the same exercise price but which

expire in different months (i.e. sell the nearby month, buy the far away month). Margin may be required.

**time value** Another name for extrinsic value. This important factor helps to determine how much an option is worth.

**trading account** An account opened with a brokerage firm from which to place trades. Opening an account takes several steps including signing a risk disclosure statement (a document which indicates that the signer understands the risks involved in trading), performance bond agreement (binds the trader to pay for any losses incurred in the course of trading), and a futures account agreement (outlines how the account is to be handled by the broker).

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## U

**upside** The potential for prices to move up. Also the potential risk taken on a directional trade.

**underlying asset** The stock, commodity, futures contract or cash index to be delivered in the event an option is exercised.

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## V

**variable delta** A delta that can change due to the change of an underlying asset or a change in time expiration of an option.

**vega** The speed of the options price relative to the change in the underlying. This is also referred to as the volatility of the market.

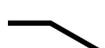
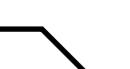
**volatility** Measure of the magnitude of price or yield changes over a predefined period of time. Volatility is used as a primary determinant in the valuation of options models.

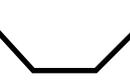
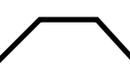
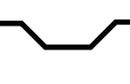
**volume (vol)** The total volume for a security or derivative in a certain time frame.

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## Y

**yield** The return on an investment in a given period of time.

STRATEGY	RISK PROFILE	STRATEGY	MARKET OUTLOOK	PROFIT POTENTIAL	RISK POTENTIAL	TIME DECAY EFFECT
<b>BULLISH</b>						
Long Call		B1-C	Bullish	Unlimited	Limited	Detrimental
Short Put*		S1-P	Bullish	Limited	Unlimited	Helpful
Covered Call*		B1-U S1-C	Slightly Bullish to Neutral	Limited	Unlimited	Helpful
Bull Call Spread		B1-LC S1-HC	Bullish	Limited	Limited	Mixed
Bull Put Spread		B1-LP S1-HP	Moderately Bullish	Limited	Limited	Mixed
Call Ratio Backspread		S1-LC B2-HC	Very Bullish	Unlimited	Limited	Mixed
<b>BEARISH</b>						
Short Call*		S1-C	Bearish	Limited	Unlimited	Helpful
Long Put		B1-P	Bearish	Unlimited	Limited	Detrimental
Covered Put*		B1-U S1-P	Slightly Bearish to Neutral	Limited	Unlimited	Helpful
Bear Call Spread		S1-LC B1-HC	Moderately Bearish	Limited	Limited	Mixed
Bear Put Spread		B1-HP S1-LP	Bearish	Limited	Limited	Mixed
Put Ratio Backspread		S1-HP B2-LP	Very Bearish	Unlimited	Limited	Mixed

STRATEGY	RISK PROFILE	STRATEGY	MARKET OUTLOOK	PROFIT POTENTIAL	RISK POTENTIAL	TIME DECAY EFFECT
<b>NON DIRECTIONAL</b>						
Long Straddle		B1-ATM-C B1-ATM-P	Volatile	Unlimited	Limited	Detrimental
Short Straddle*		S1-ATM-C S1-ATM-P	Stable	Limited	Unlimited	Helpful
Long Strangle		B1-OTM-C B1-OTM-P	Volatile	Unlimited	Limited	Detrimental
Short Strangle*		S1-OTM-C S1-OTM-P	Stable	Limited	Unlimited	Helpful
Long Synthetic Straddle		B1-U/B2-ATM-P OR S1-U/B2-ATM-C	Volatile	Unlimited	Limited	Detrimental
Short Synthetic Straddle*		B1-U/S2-ATM-C OR S1-U/S2-ATM-P	Volatile	Limited	Unlimited	Helpful
Call Ratio Spread*		B1-LC S2-HC	Bearish Stable	Limited	Unlimited	Mixed
Put Ratio Spread*		B1-HP S2-LP	Bullish Stable	Limited	Unlimited	Mixed
Call Calendar Spread		B1-LTC S1-STC	Stable	Limited	Limited	Helpful
Put Calendar Spread		B1-LTP S1-STP	Stable	Limited	Limited	Helpful
Long Butterfly		B1-LC, S2-HC B1-HC OR B1-LP S2-HP B1-HP	Stable	Limited	Limited	Helpful
Short Butterfly		S1-LC, B2-HC S1-HC OR S1-HP B2-HP S1-HP	Bullish Bearish	Limited	Limited	Detrimental
Long Condor		B1-LC S1-HC S1-HC B1-HC OR B1-LP S1-HP S1-HP B1-HP	Stable	Limited	Limited	Helpful
Short Condor		S1-LC B1-HC B1-HC S1-HC OR S1-LP B1-HP B1-HP S1-HP	Bullish Bearish	Limited	Limited	Detrimental
Long Iron Butterfly		S1-ATM-C B1-OTM-C S1-ATM-P B1-OTM-P	Stable	Limited	Limited	Helpful
Short Iron Butterfly		B1-ATM-C S1-OTM-C B1-ATM-P S1-OTM-P	Bullish Bearish	Limited	Limited	Detrimental